

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:FS:LI:TL-N-4416-01, POSTF-150454-01  
DRMirabito

date: November 20, 2001

to: Denis Bricker, Group Manager, Group 1348  
Attention: Revenue Agent Angelo Buonconsiglio

from: Jody Tancer, Associate Area Counsel  
(Financial Services:Long Island)

subject:

EIN [REDACTED]

This responds to your memorandum dated July 17, 2001 as supplemented with additional factual material on August 13, 2001 requesting advice on whether amounts may be recaptured under Internal Revenue Code § 465. This memorandum should not be cited as precedent.

ISSUES

1. Should the Service argue that the recapture rules of Internal Revenue Code § 465(e) allow it to recompute individual shareholders' taxable income to include distributions from their Subchapter S corporation in the amounts of \$[REDACTED] and \$[REDACTED] in the taxable years [REDACTED] and [REDACTED], respectively?

2. Should the Service argue that the shareholders received unreported taxable constructive corporate distributions/dividends in the amounts of \$[REDACTED] and \$[REDACTED] in the taxable years [REDACTED] and [REDACTED], respectively?

CONCLUSIONS

1. The Service should not use § 465(e) to recompute the individual shareholders' taxable income to include corporate distributions in the taxable years [REDACTED] and [REDACTED], respectively.

2. The Service may argue that the shareholders received unreported taxable constructive corporate distributions/dividends in the amounts of \$[REDACTED] and \$[REDACTED] in the taxable years [REDACTED] and [REDACTED], respectively.

FACTS

The facts, as we understand them, are as follows:

[REDACTED] EIN [REDACTED] (or taxpayer), timely filed its Forms 1120S for the calendar years [REDACTED] and [REDACTED]. Schedules K-1 attached to those returns listed [REDACTED] as owner of [REDACTED] of the outstanding shares, and [REDACTED] as owner of [REDACTED] of the outstanding shares. [REDACTED] and [REDACTED] (the shareholders) are also listed as the only officers, and it appears from the Form 1120S for the [REDACTED] taxable year that [REDACTED] held the office of President. The returns stated that the taxpayer was incorporated on January 1, [REDACTED].

[REDACTED]'s subject Form 1120S for the [REDACTED] taxable year claimed an ordinary loss in the amount of (\$[REDACTED]). The return claimed a deduction for compensation of officers on line 7 in the total amount of \$[REDACTED]. In addition, the two Schedules K-1, Shareholders' Shares of Income, Credits, Deductions, etc., attached to the Form 1120S, reported on Lines 20, total property distributions (including cash) other than dividends reported on line 22, in the total amount of \$[REDACTED]. Schedule M-2 (Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed) reported on Line 7, Distributions other than dividend distributions, the amount of \$[REDACTED]. The same schedule reports the amount of \$[REDACTED] as the Accumulated adjustments account. The Schedule L attached to this return reported on line 7 that the amount of loans to shareholders decreased from \$[REDACTED] to \$[REDACTED] as of the end of the tax year.

To their joint income tax return (Form 1040) for the taxable year [REDACTED], [REDACTED] attached Statement 2, Schedule E, Page 2, Part II-Partnerships and S Corporations, listing certain S corporations and whether all or some of their investment was at risk. For [REDACTED], the shareholders indicated they had some investment at risk, although the amount at risk is not included. However, Forms 6198, At-Risk Limitations, attached to the Form 1040 for [REDACTED] all report the amount of \$[REDACTED] as their adjusted basis on line 6 as Adjusted basis and the amount of \$[REDACTED] on line 10, Amount at risk. Further, on Schedule D, Part II-Long-Term Capital Gains and Losses-Assets Held More Than One Year, the shareholders reported a total of \$[REDACTED] on Line 10, Total long-term sales price amounts, from [REDACTED]. In addition, they reported taxable wages, etc. on line 7 in the amount of \$[REDACTED].

[REDACTED]'s [REDACTED] Form 1120S claims on line 21 an ordinary loss

from trade or business activities in the amount of (\$ [REDACTED]). Again, a deduction for compensation of officers is claimed on line 7 in the total amount of \$ [REDACTED]. The Form 1120S does not report any amount on Schedule M-2, Line 7, Distributions other than dividend distributions. Moreover, Schedule M-2, column (a) Accumulated adjustments account, reports the amount of \$ [REDACTED]. However, Schedule L attached to this Form 1120S states that the loans to shareholders (Line 7) increased from \$ [REDACTED] at the beginning of the tax year to \$ [REDACTED] at the end of tax year. The shareholders' Form 1040 does not report any capital gain or loss on Line 13. Statement 3, Schedule E, Page 2, Part II-Partnerships and S Corporations, again reports some investment at risk for [REDACTED] but no amount is stated. Also, Forms 6198 for [REDACTED] again report the amount of \$ [REDACTED] on line 6, Adjusted basis, and the amount of \$ [REDACTED] on line 20, Amount at risk. The shareholders report taxable wages, etc. on line 7 in the total amount of \$ [REDACTED].<sup>1</sup>

We understand from the agent that [REDACTED]'s shareholders absorbed losses and took distributions from the company such that their at risk amounts were [REDACTED] as of December 31, [REDACTED]. In addition, we understand from the agent that [REDACTED] had no earnings and profits in either of the taxable years [REDACTED] or [REDACTED]. In support of this statement, we refer to the large negative accumulated adjustments account amounts reported on the corporate returns in issue as noted above. Moreover, we understand from the agent that the shareholders agree that both their at risk amount and their basis in [REDACTED] equaled [REDACTED] in [REDACTED] and [REDACTED].

For the [REDACTED] taxable year, the revenue agent proposes to make a net adjustment of \$ [REDACTED] due to allowances and disallowances of certain corporate expenses. He further determined that constructive distributions to the individuals equaled \$ [REDACTED] pertaining to the corporation's payment of their personal expenses. The revenue agent summarized these changes as follows:

Taxable Year [REDACTED]

Basis held by shareholders	\$ [REDACTED]
At-risk held by shareholders	[REDACTED]

Taxable Year [REDACTED]

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<sup>1</sup> We do not know why the amounts claimed by [REDACTED] as deductions for officer compensation in [REDACTED] and [REDACTED] do not equal the amount of wages, etc. reported by the shareholders on their Forms 1040 for those years.

Distribution per return (1120S) \$ [REDACTED]  
 Loss per return (1120S) [REDACTED]  
 Adjustments to income (1120S) per agent [REDACTED]  
 Corrected loss [REDACTED]

Distribution to shareholders per audit [REDACTED]  
 Shareholders reported capital distribution [REDACTED]  
 Corrected capital gain distribution [REDACTED]  
 Post-distribution basis of shareholders [REDACTED]  
 Post-distribution At-risk of shareholders [REDACTED]

The agent proposes to make the following adjustment to the corporate return for [REDACTED]; again, the constructive distributions in the amount of \$ [REDACTED] represent payment of shareholder personal expenses. The agent summarized this adjustment as follows:

Taxable Year [REDACTED]

Basis held by shareholders \$ [REDACTED]  
 At-risk held by shareholders [REDACTED]

Loss per return (1120S) \$ [REDACTED]  
 Audit adjustments [REDACTED]  
 Corrected loss [REDACTED]

Distribution to shareholders per audit [REDACTED]  
 Post-distribution basis [REDACTED]  
 Post-distribution At-risk of shareholders [REDACTED]

The revenue agent takes the position that the recapture rules of Internal Revenue Code § 465 apply since the at risk amount at the end of [REDACTED] is negative and prior year losses have been absorbed. According to the agent, the [REDACTED] capital gain distribution as adjusted to \$ [REDACTED] reduces the shareholders' at risk amount below [REDACTED] and must therefore be reported as taxable income. Similarly, the [REDACTED] recapture amount would be \$ [REDACTED] since the distribution of this amount again reduced the at risk amount below [REDACTED].<sup>2</sup>

ANALYSIS

Issue 1. Application of § 465(e)

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<sup>2</sup> Please note that we offer no opinion in this memorandum on the agent's calculation of the amounts of recapture income nor on whether his proposed corporate audit adjustments should be made.

Internal Revenue Code § 465(a) provides, in pertinent part, that an individual, engaged in an activity to which the section applies, may claim a loss from such activity for the taxable year to the extent of the aggregate amount to which the taxpayer is at risk within the meaning of § 465(b). The latter section, in turn, provides that a taxpayer shall be considered at risk with respect to amounts including the amount of money and adjusted basis of other property contributed by the taxpayer to the activity.

However, § 465(e) states,

465(e)(1) In General.-If zero exceeds the amount for which the taxpayer is at risk in any activity at the close of any taxable year--

465(e)(1)(A) the taxpayer shall include in his gross income for such taxable year (as income from such activity) an amount equal to such excess, and

465(e)(1)(B) an amount equal to the amount so included in gross income shall be treated as a deduction allocable to such activity for the first succeeding taxable year.

Temp. Treas. Reg. § 7.465-2 provides generally that the amount a taxpayer is at risk initially shall be the taxpayer's initial basis in the activity. However, under subsection (d) of this regulation, in no event shall the amount at risk be less than zero. Prop. Treas. Reg. § 1.465-10(a) provides generally that in the case of electing small business corporations, the at risk rules of § 465 apply at the shareholder level. Thus, each shareholder is allowed a loss only to the extent that the shareholder is at risk.

Despite the plain language of § 465 and the above referenced regulations, it is the position of the Office of Chief Counsel that the Service should not use this statute to recapture any unreported corporate distributions in this case. This is based on the ability of the shareholders to argue that they would be entitled to an offsetting deduction under Prop. Treas. Reg. § 1.465-22 as the recaptured amount would increase their at risk amount. Prop. Treas. Reg. § 1.465-22(b) states that a taxpayer's amount at risk in an activity shall be decreased by the amount of money withdrawn from the activity on behalf of the taxpayer. However, Prop. Treas. Reg. § 1.465-22(c) states, in pertinent part,

(1) Income. A taxpayer's amount at risk in an activity shall be increased by an amount equal to the excess of the taxpayer's share of all items of income received or accrued from the activity during the taxable year over the taxpayer's share of allowable deductions which are allocable to the activity for the taxable year.

The [REDACTED] at risk amount will increase by the amount of each distribution from [REDACTED] under this regulation. However, the reduction of at risk amount under § 1.465-22(b) would be offset by the income recognition under 1.465-22(c).

In addition, this position is based on legislative intent, that is, Congress did not intend § 465(e) to be used in the manner proposed by the agent. Rather, Congress enacted § 465(e) to prevent taxpayers from artificially inflating their basis in order to entitle them to deductions resulting from investments in the abusive tax shelters common in the late 1970s. In furtherance of this intent, Prop. Treas. Reg. § 1.465-4(a) provides that if a taxpayer engages in a pattern of conduct not within usual business practice or has the effect of avoiding the provisions of § 465, the Service may adjust the taxpayer's amount at risk to more accurately reflect the actual amount at risk. Thus, under this proposed regulation, the Service will closely examine increases in at risk amounts occurring toward the close of a taxable year having the effect of increasing the amount of losses which will be allowed taxpayer under § 465 for the taxable year. However, if such examination, considering all the facts and circumstances, discloses that the event increasing the amount at risk at the close of the taxable year will be accompanied by an event decreasing the amount at risk after the close of the taxable year, the amount apparently at risk will be disregarded in determining the actual amount of risk unless the taxpayer establishes the existence of a valid business purpose for increasing and decreasing the amount at risk and that the increases/decreases are not a device for avoiding § 465. However, the shareholders here have not engaged in this type of prohibited artificial increasing and corresponding decreasing of their at risk amounts. Rather, they have simply used their corporation to pay their personal expenses.

The agent has called our attention to the provisions of Prop. Treas. Reg. § 1.465-95, Effective date, LR-168-76, 6/5/79. In light of all the above, we do not think that this regulation allows the agent to take the proposed action since it does not provide any substantive provisions for taxpayers and the Service to follow. Similarly, our attention has been called to the

provisions of Prop. Treas. Reg. § 1.465-12, Definition of loss; income from the activity, LR-168-76, 6/5/79. We do not think this regulation is directly on point here as it pertains to income received from an activity as gain recognized upon the disposition of the activity or an interest in the activity. However, we note that its provisions, especially the example in which the amount of gain to be recognized in gross income for a taxable year equals the amount of deduction allowable for that same taxable year, support the position above that the shareholders here would be allowed an offsetting deduction under Proposed Treas. Reg. § 1.465-22. Nor do we think Rev. Rul. 95-5, 1995-1 C.B. 100, applies in the instant case as it pertains to characterization of gain for purposes of the passive activity loss rules of Internal Revenue Code § 469 when a partner or S corporation shareholder receives a distribution of money in excess of their adjusted basis. Nor are we persuaded by the agent's reference to the material on page A-27, Tax Management, Inc., in light of the discussions on the offset of income and intent of Congress above. Moreover, the conclusion on page A-27 that the income will be taxable may also be reached using a constructive dividend/distribution argument. That is, as an alternative to using § 465(e) to increase the shareholders' taxable income for [REDACTED] and [REDACTED] the Service may argue, as discussed in detail below, that the corporate distributions are taxable as constructive dividends/distributions.

## Issue 2. Constructive dividends/distributions

In pertinent part, Internal Revenue Code § 1368(a) provides that a distribution of property made by an S corporation shall be treated as provided in subsection (b). That subparagraph provides that in the case of a distribution of property made by an S corporation with no accumulated earnings and profits, if the amount of the distribution exceeds adjusted basis of stock, such excess shall be treated as gain from the sale or exchange of property. See also Treas. Reg. § 1.1368-1(c). We assume for purposes of this memorandum that [REDACTED] had no earnings and profits based upon information from the agent as well as the large ordinary losses claimed on both of the subject corporate returns and the substantial negative accumulated adjustments account amounts also reported on the returns as detailed above. We further assume that the distributions in question exceed the [REDACTED] adjusted basis of stock, based on the information provided by the agent and the shareholders on their Forms 1040 as detailed above.

Section 1368(a) also refers to Internal Revenue Code § 301(c). Section 301(c)(1) provides that the portion of a distribution which is a dividend shall be included in gross

income. Section 301(c)(3)(A) further provides that the portion of the distribution that is not a dividend, to the extent it exceeds the shareholders' adjusted basis, shall be treated as gain from the sale or exchange of property. As defined in Internal Revenue Code § 316(a), "dividend" has two characteristics: (1) it is any distribution of property made by a corporation to its shareholders and (2) it is a distribution made from corporate earnings and profits. Moreover, Internal Revenue Code § 1371(a) states that except as otherwise provided in the Code and except to the extent inconsistent with this subchapter, subchapter C shall apply to S corporations and their shareholders. Please note, however, that § 1368(b) explicitly provides for the treatment of distributions by S corporations having no earnings and profits. Accordingly, reading §§ 316(a) and 1371(a) together, the first characteristic of a dividend under § 316, that a dividend is any distribution of property, applies to [REDACTED] and its shareholders. However, reading §§ 316(a), 1371(a), and 1368(b) together, the second characteristic of a dividend, as a distribution from earnings and profits, does not pertain to [REDACTED]. See Jones v. Commissioner, T.C. Memo. 1997-400, aff'd per curiam on unspecified issues, 99-1 U.S.T.C. ¶ 50,389 (11<sup>th</sup> Cir. 1999) (the factors used in deciding whether distributions by a C corporation are dividends equally applicable to distributions by an S corporation except the history of earnings and profits).

Lastly, Internal Revenue Code § 1366 provides that in determining the amount of tax owed by a shareholder in an S corporation, there shall be taken into account the shareholder's pro rata share of the corporate items of income and that the shareholder's gross income shall include the pro rata share of the corporation's gross income. Further, Treas. Reg. § 1.1366-1(a) states that the shareholder is required to take into account in their return the shareholder's pro rata share, **whether or not distributed**, of the corporate items of income. (emphasis added).

Taken together, this statutory framework allows the Service to include in the [REDACTED] gross income the unreported distributions made to them by [REDACTED] in [REDACTED] and [REDACTED].

Many courts have held that corporate expenditures made for the personal benefit of a shareholder may result in a constructive dividend to that shareholder. Broad v. Commissioner, T.C. Memo. 1990-317; Ireland v. United States, 621 F.2d 731 (5<sup>th</sup> Cir. 1980); Enoch v. Commissioner, 57 T.C. 781 (1972), acq. in part, 1974-2 C.B. 2, AOD /0312.07-00 (December 7, 1972). In addition, the fact that dividends are not formally declared will not preclude the existence of constructive



dividends. Truesdell v. Commissioner, 89 T.C. 1280, 1295 (1987), acq. 1988-2 C.B. 1. Rather, the crucial concept is that the corporation has conferred an economic benefit on the shareholder without expecting repayment. Id.; United States v. Smith, 418 F.2d 589, 593 (5<sup>th</sup> Cir. 1969). Moreover, based upon assignment of income principles as enunciated in Helvering v. Horst, 311 U.S. 112 (1940), the shareholder is taxed on the distribution of corporate earnings made at his demand or request to a third party for some purpose or obligation even if the shareholder may have personally received no direct benefit. Hufnagle v. Commissioner, T.C. Memo. 1986-119. In Peters, Gamm, West & Vincent, Inc., et al. v. Commissioner, T.C. Memo. 1996-186, the Court stated,

In our case, legal fees were paid by PGWV, .. there was no expectation of repayment, and the payment directly benefitted Peters. We therefore find that the payment of the legal fees constituted a distribution to Peters; we make no decision as to the characterization of the distribution, either as income to Peters, a loan to him, or a return of capital; it is not necessary to our conclusion that Peters received a constructive distribution of the funds which in turn were used to pay the legal charges incurred for his benefit. We hold that Peters was in constructive receipt of the distribution in the amount of the legal fees ...

In the instant case, we assume that [REDACTED] did not expect the shareholders to repay the amounts spent on their personal expenses. Our assumption is supported by the facts that [REDACTED] are the sole shareholders and officers of the corporation and thus presumably control corporate actions and affairs and that the corporation increased its loan to shareholders account as reported on the [REDACTED] Form 1120S by \$[REDACTED].<sup>3</sup> However, please note that the Form 1120S for the [REDACTED] taxable year reported a decrease in this account, which may indicate an intent to expect repayment. Further, we assume that the agent correctly determined the payments made by [REDACTED] were for the shareholders' personal benefit and had no business purpose.

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<sup>3</sup> You may wish to further investigate this significant increase in the loans to shareholders, especially since the Form 1120S for the [REDACTED] taxable year reported a decrease in this account.

Based on the above case law and statutes, we think the Service should take the position that the [REDACTED] received unreported taxable constructive distributions/dividends in the amounts of \$[REDACTED] and \$[REDACTED].

Please note that our opinion is based on the facts provided to us and set forth herein. Further, we have made a number of key assumptions in discussing this issue. If any of the facts change or any of our assumptions are incorrect, please contact this office at once since our opinion may change. In addition, if the facts change, this opinion should not be relied upon.

Please note that under routing procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office, which should be in approximately 10 days. In the meantime, the conclusions reached in this memorandum should be considered to be only preliminary.

Please contact Diane Mirabito at (516) 688-1709 if you have any questions.

#### DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

JODY TANCER  
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By: \_\_\_\_\_  
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